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Purchase Undertakings in Recent *Sukuk* Issuances: Different Objectives and Approaches

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In February 2008, the *Shari'a* Committee of the Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI) issued a statement[2] (the AAOIFI Statement) on *sukuk* transactions, which provides certain rules that should be adhered to in structuring *sukuk* transactions. One particular rule (the "Fourth Rule"), which restricts purchase undertakings in *sukuk* transactions, states in part that "[i]t is not permissible for the *mudarib* (investment manager), *sharik* (partner), or *wakil* (investment agent) to agree to purchase assets from *Sukuk* holders or from whoever represents them for a nominal value of those assets at the time the *Sukuk* are extinguished at the end of their tenors."[3] This paper examines the structure and use of purchase undertakings in a number of recent *sukuk* transactions that originated in Gulf Cooperation Council ("GCC") countries, considers the commercial objectives underlying these transactions, and evaluates their adherence to the Fourth Rule. We will seek to demonstrate that there is a certain variety in the structures adopted, which reflects the varying commercial objectives of the transactions in question, and that current transactions appear to adhere to the Fourth Rule in varying degrees. We will look at three categories of transaction structures and briefly examine the way in which rating agencies approach their analysis for these types of transactions. While the *shari'a*-based evaluation of the transactions (and how they should be considered in light of the Fourth Rule) is ultimately a matter of judgment by Islamic

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[1] Partners, Clifford Chance LLP, United Kingdom.

[2] Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), "Statement in Relation to *Sukuk*," February 2008.

[3] Ibid.

scholars, we nonetheless hope that our analysis of the transactions as professional lawyers may help to clarify the structures used and add to the discourse surrounding *sukuk* transactions.

PURCHASE UNDERTAKINGS IN *SUKUK-AL-MUSHARAKA*

The first category of transaction structure that we wish to examine is the *sukuk-al-musharaka*. This structure has been adopted in a significant number of recent large *sukuk* issues originated by corporations in the GCC region, including the US $3.5 billion issue of Trust Certificates by PCFC Development FZCO ("DP World") in 2006,[4] and the AED 7.5 billion issue of Trust Certificates by JAFZ *Sukuk* Limited (Jebel Ali Free Zone) in 2007.[5] The main objective of these transactions has been fund-raising, often for corporate acquisitions, or major development or infrastructure projects.

Before examining the purchase undertakings themselves, it is important to have an understanding of the context in which they are used. Therefore, we set out below a brief description of the *sukuk-al-musharaka* structure as a whole.

A *musharaka* is a partnership. In a typical *sukuk-al-musharaka* structure, the two partners would be the sponsor or originator of the transaction (and the party raising the financing) (the "Originator") on the one hand, and a special purpose company (SPV) (the "*Sukuk* Issuer") on the other. The *Sukuk* Issuer contributes cash to the partnership (*musharaka*), which it raises through the issuance of *sukuk*, and the Originator contributes assets in kind. Units in the *musharaka* ("Units") are issued to the *Sukuk* Issuer and the Originator in relation to their respective contributions. The *Sukuk* Issuer and the Originator, as parties in the *musharaka*, will typically also draw up a business plan regarding the employment of the *musharaka*'s assets and appoint a managing agent to act on behalf of the *musharaka*. (In practice this managing agent will often be the Originator.)

During the life of the transaction, the *musharaka*'s assets will generate income or profit and this will be paid to the Originator and the *Sukuk* Issuer in pre-agreed proportions, with the *Sukuk* Issuer typically

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[4] PCFC Development FZCO, Offering Circular relating to U.S.$ 3.5 billion Trust Certificates due 2008, January 20, 2006.

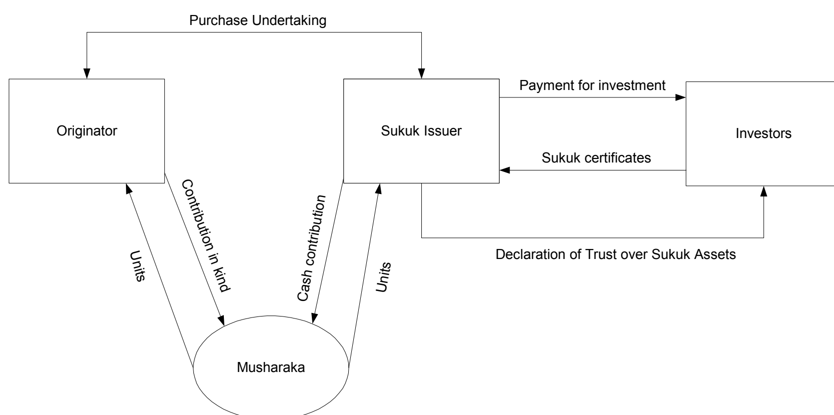
[5] JAFZ *Sukuk* Limited, Prospectus relating to AED 7,500,000,000 Trust Certificates due 2012, November 21, 2007.

being entitled to receive out of such income a pre-set amount determined by reference to, say, a particular interest rate. Such amounts are often termed "Periodic Distribution Amounts."

In these structures it is usually the case that a purchase undertaking is entered into by the Originator in favour of the *Sukuk* Issuer. This will generally be a full recourse undertaking by the Originator to purchase from the *Sukuk* Issuer its Units in the *musharaka*, normally at their original book value (which matches the face or principal amount of *sukuk* in issue).

The *Sukuk* Issuer will in turn then establish the *sukuk* by declaring itself trustee over the *sukuk* assets in a trust instrument and issuing certificates (*sukuk*) to investors representing undivided shares in the *sukuk* assets. Note that in this structure the *sukuk* assets are not the assets contributed to the *musharaka*, but rather the *Sukuk* Issuer's Units and its rights under the purchase undertaking. Accordingly, investors are effectively put in the position of having direct recourse against the Originator through the purchase undertaking. As we shall see, this is a key element of the structure and is of particular importance in terms of how these transactions are analyzed by rating agencies.

The above transaction structure is illustrated in the following diagram:



Although other circumstances are at times also included, purchase undertakings are generally exercisable in these transactions by the *Sukuk* Issuer at least (a) at scheduled maturity, and (b) following the occurrence of events and circumstances (collectively, "Dissolution Events") set out in the terms and conditions of *sukuk* under which the

trust that is the subject of the *sukuk* may be dissolved early (i.e., accelerated) at the option of the *sukuk*-holders. Generally speaking, the ability to exercise purchase undertakings following the occurrence of Dissolution Events serves the same purpose as events of default in a loan agreement or bond issue. Dissolution Events will commonly include, among other things, non-payment and insolvency of the *Sukuk* Issuer (which is invariably a bankruptcy-remote special purpose company, and so in practice these are of little importance), but also, and most important, events of default under the purchase undertaking itself. These latter events of default will normally relate to the Originator and may include a full set of corporate loan or bond-style events of default, including cross-default provisions and breaches of covenant by the Obligor.

There are thus two main purposes for purchase undertakings in these structures. First, it provides for a relatively straightforward mechanism for unwinding the *musharaka* at the scheduled maturity of the *sukuk*. Second, it provides for a means to accelerate and unwind the structure prior to the final maturity in circumstances where there has been an event of default or similar such event affecting the Originator or else some other change in circumstances that entitles investors to terminate their investment early. In each case, there will typically be full recourse to the Originator, and thus it also provides a contractual obligation that rating agencies are able to assess and effectively treat as the underlying credit in the transaction. Such purchase undertakings also usually provide for the price at which the units are purchased from the *Sukuk* Issuer to be a price fixed at the outset rather than a price established by reference to market prices at the time that the units are repurchased or otherwise established by reference to prevailing circumstances at such time. As mentioned above, this is normally equal to the outstanding nominal amount of the *sukuk* and sometimes also includes any prior shortfalls in Periodic Distribution Amounts to the extent that there was insufficient income generated by the *sukuk* assets to cover such amounts.

The overall effect of this is that the purchase undertaking amounts to a direct undertaking given to the *Sukuk* Issuer by the Originator, under which an event of default in relation to, or breach of covenant by, the Originator will potentially lead to an obligation on the part of the Originator to buy the *Sukuk* Issuer's units at par. While such obligation is not given directly in favor of investors, but rather to the *Sukuk* Issuer as their trustee, it is not difficult to see how similar the position of

sukuk-holders in this structure is to that of holders of regular corporate bonds with the benefit of a guarantee from the Originator.

That said, there are a number of important differences between a purchase undertaking and a bond guarantee, even where the purchase undertaking is structured in this manner. An English law euro-bond guarantee is usually written as a guarantee and indemnity, giving investors an immediate right to sue for payment of a liquidated sum equal to any due and unpaid principal and interest. A purchase undertaking, on the other hand, is an executory contract for the sale and purchase of an asset, either automatically exercisable or exercisable on the instructions of *sukuk*-holders. Under English law, a failure by the Originator to comply with its obligations under the purchase undertaking would not automatically entitle the *Sukuk* Issuer to sue for a liquidated sum. Instead the *Sukuk* Issuer would need to petition the court for specific performance of the purchase obligation and, if that petition was not successful, it would only be entitled to a claim in damages for the difference between the contractual price specified in the purchase undertaking for the *sukuk* assets and their market price as of the date that the purchase obligation matured. As the award of specific performance is discretionary for an English court, the *Sukuk* Issuer (and thus investors) is in a less advantageous position than where there is a guarantee (properly so-called).

From a technical legal perspective, at least, it is accordingly misleading to describe purchase undertakings as guarantees.

Jebel Ali Free Zone *Sukuk* Issue

The Jebel Ali Free Zone ("JAFZ") *Sukuk* issue is a good example of the use of a purchase undertaking in this type of structure. In this transaction, Jebel Ali Free Zone FZE (the Company) entered into a *musharaka* with JAFZ *Sukuk* Limited, as *Sukuk* Issuer, under which the *Sukuk* Issuer contributed the proceeds of the *Sukuk* and the Company contributed certain assets in kind.

The Company also entered into a purchase undertaking as obligor in favor of the *Sukuk* Issuer. The terms of this purchase undertaking included an undertaking restricting the giving of security by the Company and its subsidiaries and also a covenant requiring asset sales to be for fair market value. In addition, the purchase undertaking included the following events of default:

- non-payment
- breach of other obligations
- cross-acceleration
- enforcement proceedings
- security enforced
- insolvency
- winding-up
- authorization and consents
- illegality

This package of covenants and events of default is very similar to what one would commonly find in a conventional interest-bearing euro-bond issued by an issuer in the GCC region.

The purchase undertaking in the JAFZ transaction is exercisable by the *Sukuk* Issuer at scheduled maturity, in the event of a change of control in the Company, and upon the occurrence of a "Dissolution Event." The latter includes the occurrence of any of the above-listed events of default under the purchase undertaking. All payments by the Company under the purchase undertaking are also required to be grossed-up for any withholding taxes levied on payments by the Company, and the Company also agrees in the transaction documents to pay the *Sukuk* Issuer additional amounts to cover any required withholdings or deductions to payments under the *sukuk* themselves.

The overall effect of these arrangements is to give investors recourse to the Company that is similar, but not identical, to what they would have in a conventional bond issue (not identical, as a purchase undertaking is not a guarantee, for the reasons discussed above). This degree of recourse and linkage to the underlying originator also allows rating agencies to give ratings to *sukuk* structured in this manner at the same level as the ratings that apply to an originator's senior unsecured debt (see further below).

While the *shari'a*-based evaluation of such transactions (and how they should be considered in light of the Fourth Rule) is ultimately a matter of judgement by Islamic scholars, at first impression, the aforementioned structure appears to contravene the Fourth Rule since the obligor under the purchase undertaking is often the same entity as the partner in the *musharaka* and the purchase price for the *Sukuk* Issuers Units will typically be their original face value.

SECURITIZATION STRUCTURES

At the other end of the spectrum are transactions that are closer to securitizations in their structure and degree of recourse to the Originator. Such transactions may properly be described as asset-backed, whereas the first category of *sukuk* we have examined might more accurately be described as asset-based. To date, there have been relatively few such transactions in GCC countries, partly because of perceived local law difficulties relating to the certainty of transfers of property rights and other issues relating to enforcement.

A common goal of securitization transactions where the originator is a financial institution is to remove the assets that are the subject of the securitization from the balance sheet of the originator from an accounting and/or a regulatory capital perspective. This typically requires the relevant assets to be sold outright by means of a "true sale." The features of what is treated as a true sale may vary depending on the jurisdiction of the originator and the location of the assets in question. However, it is generally accepted in English law that the answers to the following questions are all relevant considerations, namely:

(a) Does the purchaser have recourse to the seller in the event that the asset purchased is worth less than the amount he paid to the seller?
(b) Conversely, is the purchaser required to account to the seller for any profit he makes on a sale of the assets?
(c) Does the seller have the right to get back the subject matter of the sale by returning to the purchaser the money that has passed between them?

Similar considerations often apply in other jurisdictions.

Another way of expressing the first of these considerations is to say that in a true sale the purchaser typically runs a significant degree of risk on the assets and generally speaking the assets will be the primary source of repayment, whereas in a loan financing transaction secured on the same assets there will be full recourse to the borrower if the assets do not generate sufficient funds to repay the financing.

With that said, it is nonetheless common to find a degree of recourse to the originator even in true sale securitisations. However, depending on the jurisdiction, this is often limited to circumstances

where the assets that are the subject of the securitization fail to meet certain pre-agreed criteria or other pre-defined standards relating to the origination of the assets are not met. In the case of a securitisation of, say, real estate mortgage loans, these criteria would normally fall short of prospectively requiring full repayment of the loans by the underlying borrowers; to allow recourse to the originator in these circumstances would be tantamount to the originator guaranteeing full repayment of the loans, which in turn will generally have the effect of placing the mortgage loans back on the originator's balance sheet, whether from an accounting or a regulatory perspective, as the originator would remain "on risk." (Note, however, that, under English law, at least, such a guarantee of receivables would not necessarily result in a transaction being characterized as a loan financing secured on receivables rather than a financing by way of a sale of receivables.) In essence, the purchaser may have a limited right to put back to the originator defective assets, but only where they differ *at the time of purchase* from the assets that the purchaser has bargained for.

It should accordingly come as no surprise that the function and features of a purchase undertaking in a securitization-type asset-backed transaction is quite different from that of a purchase undertaking in the first category of transactions. So as not to jeopardize the true sale analysis and the attendant regulatory and accounting benefits, one would expect the circumstances in which the purchase undertaking could be exercised to be much more limited.

Tamweel

The US $210 million issue of Floating Rate Notes due 2037 by Tamweel Residential ABS CI (1) Ltd ("Tamweel") in 2007 is a good example of the use of a purchase undertaking in this type of asset-backed transaction. (The Tamweel transaction represents a number of "firsts" for the GCC region, being not only arguably the first true securitization, but also the first such transaction to provide for differently ranking classes of securities.)

In this transaction, the Originator was Tamweel PJSC, a UAE company whose principal business consists of providing *shari'a*-compliant home financing solutions to real estate buyers and end-users in the UAE. While the details of the transaction are somewhat complex (as is any residential mortgage-backed securitization (RMBS)), in essence the transaction consisted of the Originator selling to a DIFC-

incorporated special purpose company, Tamweel Properties (1) Ltd ("TPL"), its interests in a portfolio of properties and the related financing and leasing arrangements (collectively, the "Assets"). TPL in turn declared a trust over such Assets in favour of a Cayman Islands incorporated Company (the "Issuer"), which issued securities to investors.[6]

In the sale documentation relating to the transfer of the Assets to TPL, the Originator gave TPL a large number of representations and warranties relating to the Assets (collectively, the "Tamweel Warranties"). These cover a comprehensive list of factual matters, ranging from the Originator having good title to the Assets, to whether there is access to the relevant properties over public roads or whether any of the underlying borrowers/lessees were materially in default under the financing arrangements. Importantly, however, these representations and warranties are given only at the time of, or immediately prior to, the sale of the relevant Assets to TPL. So long as such representations and warranties were true at the time they were given, neither TPL nor the Issuer will have recourse to the Originator if circumstances subsequently change so that they would no longer be true if they were repeated. Accordingly, under these representations and warranties TPL (and ultimately investors) bears the risk of subsequent changes in circumstances relating to the Assets, such as a deterioration in the ability of the underlying borrowers/lessees to pay.

The transaction also includes a purchase undertaking entered into by the Originator (as obligor) in favor of TPL (as promisee). However, the scope of this purchase undertaking is relatively limited. It may only be invoked if either (a) one of the Tamweel Warranties was untrue when given and remains unremedied when repeated 30 days after written notice to Tamweel (i.e., there is a 30 day cure period), or (b) a borrower/lessee does not consent or otherwise objects within a specified timeframe to the relevant property being transferred into the securitization. Upon exercise of the purchase undertaking the Originator is required to repurchase from TPL its rights to the relevant property and related arrangements at a pre-defined repurchase price.

The following diagram sets out a simplified overview of the elements of the Tamweel transaction structure discussed in this paper.

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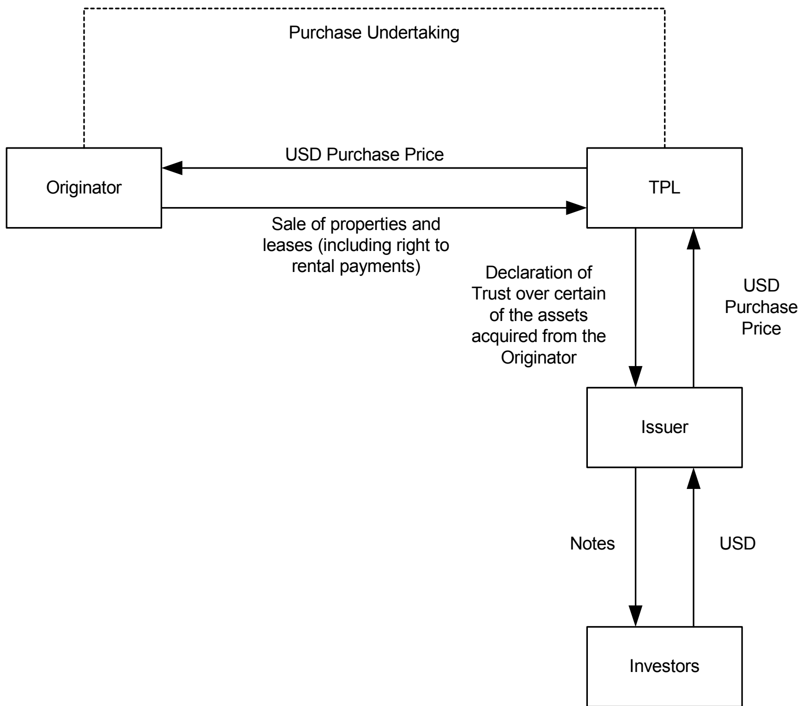
[6] Tamweel Residential ABS CI (1) Ltd, Prospectus relating to US$210,000,000 Floating Rate Secured Notes due 2037, July 19, 2007. In Tamweel, the securities are termed Floating Rate Notes rather than the more usual trust certificate.

The Tamweel transaction is very different from the *sukuk-al-musharaka* transactions discussed above, both in its overall structure and in its use of the purchase undertaking.



For our purposes, the primary difference is in the degree of recourse to the Originator through the purchase undertaking. In particular:

- Whereas in the *sukuk-al-musharaka* structures the purchase undertaking provides the mechanism by which the *Sukuk* Issuer disposes of its Units and thereby generates the funds necessary to redeem the *sukuk* at their face amount, in the Tamweel transaction, the cash flows from the underlying Assets (namely the properties and related rights) generate the redemption proceeds.
- In the *sukuk-al-musharaka* structures, the purchase undertakings include a large number of events of default and covenants that are designed to protect the creditworthiness of the Originator and/or

allow the *Sukuk* Issuer/investors to unwind the transaction upon signs of a deterioration in the Originator's ability to meet its payment obligations. Such provisions are entirely absent from the Tamweel purchase undertaking.

- In the Tamweel transaction the trigger events that allow an exercise of the purchase undertaking relate to the Assets and not to the Originator. Moreover, they only cover misrepresentations as to the nature of the Assets actually purchased as of the time of their transfer or the situation where there is a doubt as to their transferability in the first place.

In light of the different commercial objectives of the two types of transactions, none of this should be surprising. In the first category, the transaction, while asset-based, is also largely supported by the Originator. In the second type of transaction, the transaction is fully asset-backed and it is a primary goal that investors have recourse to the underlying assets but not to the Originator so long as the initial criteria for eligibility of the Assets were met.

The Tamweel transaction also appears to fit in more readily with the Fourth Rule set out in the AAOIFI Statement. Although, as described above, repurchases of assets at nominal value are not generally permitted, there is an exception in the Fourth Rule that would appear to apply to the limited circumstances in which the Tamweel purchase undertaking can be triggered: "It should be understood that the *sukuk* manager acts as guarantor of [investor] capital at its nominal value in cases of negligence or mala fides or non-compliance with stated conditions, regardless of whether the manager is a *sharik* (partner), *wakil* (agent) or *mudarib* (investment manager)."[7]

SEC AND SABIC — AN INTERMEDIATE CLASS OF TRANSACTION?

The two types of transaction we have so far examined are at either end of the spectrum in terms of the risks covered by the purchase undertaking, ranging from more debt-like asset-backed structures on the one hand to pure true sale asset-backed securitizations on the other.

However, there are also transactions that fall somewhere between these two extremes and involve investors taking a degree of risk on the

[7] AAOIFI, *Statement in Relation to Sukuk*, February 2008.

underlying assets while retaining, in many circumstances, a significant amount of recourse to the originator.

Two transactions that we consider fall into this category are Saudi Electricity Company's SAR5 billion *Sukuk* expiring 2027 and Saudi Basic Industries Corporation's SAR3 billion *Sukuk* expiring 2026[8] completed in July 2007 and July 2006, respectively.

We consider it worthwhile looking at these transactions in some detail, as they arguably succeed in meeting some of the criticisms levelled at the more debt-like structures while potentially still being treated in a manner similar to debt by rating agencies and investors.

Saudi Electricity Company ("SEC")

Saudi Electricity Company ("SEC"), as an integrated electricity generation, transmission, and distribution company, is a primary supplier of electricity in Saudi Arabia. The issue of the *sukuk* was part of SEC's strategy to diversify its sources of funding, with a particular focus on obtaining longer-term funding. The use of proceeds of the *sukuk* is described as being "general corporate purposes, including meeting working capital requirements, refinancing existing financial obligations and capital expenditure and the making of other investments."[9]

SEC is regulated by various Saudi laws relating to the electricity industry. The assets (the "*Sukuk* Assets") that are the subject of SEC's *sukuk* issue comprise SEC's rights under Council of Ministers' Resolution No. 169 and related legislation and its distribution and retail supply license granted by the Saudi Electricity and Co-generation Regulatory Authority (ECRA) (a) to read and maintain electricity consumption meters at its customers' premises, (b) to prepare, issue, and distribute bills, and (c) its entitlement to levy and receive charges in relation to (a) and (b) above.[10] These charges essentially consist of a periodic fixed tariff for the provision of metering and billing services, depending on the size of the relevant meter. For the purposes of the *sukuk* issue, SEC identified meters relating to certain of its residential

[8] SABIC's July 2007 SAR7 billion transaction was largely a repeat of this transaction.

[9] Saudi Electricity Company (SEC), Offering Circular relating to *Sukuk* expiring 2027, June 25, 2007.

[10] Ibid.

and commercial customers, and then transferred the above rights in relation to such meters to *Sukuk* Electricity Company, a newly created SEC subsidiary that was appointed as custodian for the holders of the *sukuk*.

The *sukuk* were issued by SEC itself, each of them representing an undivided beneficial ownership interest in the *Sukuk* Assets described above. They differed from the transactions previously discussed in that the *sukuk* were issued directly to investors by the Originator.

So as to deal with the day-to-day administration and management of the *Sukuk* Assets, SEC was also irrevocably engaged as *sukuk* administrator to perform the meter reading and billing services in relation to the relevant customers and meters, including invoicing for the meter reading tariff and collecting the related payments.

SEC, as *sukuk* administrator, is required to keep records of all income received in relation to the *Sukuk* Assets and, after deducting certain allowable costs, to transfer the net amount to *sukuk*-holders on a quarterly basis, up to a Periodic Distribution Amount determined by reference to Saudi interbank deposit rates ("SIBOR"). Amounts recovered in excess of this amount are credited to a reserve book-entry account maintained by SEC (Reserve) and are available to cover future shortfalls of Periodic Distribution Amounts and, on each five-year anniversary of the issue date, a potential "Extra Amount" payment equal to up to 10 percent of the face value of the *sukuk*. Accordingly, if the net income recovered from the *Sukuk* Assets was sufficient, an investor who retained its investment in the *sukuk* for the full twenty years stood to receive 40 percent of the *sukuk* face amount in payments of Extra Amounts.

In addition, holders of the *sukuk* have the right under a purchase undertaking to require the *sukuk* to be repurchased from them on each five year anniversary of the issue date, at 90 percent of their face amount at 5 years, 60 percent of their face amount at 10 years, and 30 percent of their face amount at 15 years. Note that the structure of this purchase undertaking differs from those previously described in that it is an undertaking to purchase the *sukuk* themselves rather than the *Sukuk* Assets.

An investor who exercised such right at five years would have received, subject to there having been sufficient income from the *Sukuk* Assets, a SIBOR-based quarterly return on its investment and a return of 100 percent of its capital. Put in this way, the payment profile is very much like that of a regular bond.

At first glance, as well as covering the optional repurchase right described above, the purchase undertaking appears to be similar to that in the archetypal *sukuk-al-musharaka* transactions described above in that it is potentially exercisable by or on behalf of *sukuk*-holders upon the occurrence of a fairly lengthy list of events of default consisting of the following:

- Default resulting in non-payment of Periodic Distribution Amount or Extra Amount
- Breach of other obligation
- Cross-default of *Sukuk* Administrator
- Unsatisfied judgment
- Insolvency
- Winding up
- Distribution Sector Restructuring Event
- Failure to take action
- Unlawfulness
- Non-effectiveness of *Sukuk* Assets

This list is very similar to that for the JAFZ transaction described above. However, on more careful examination one discovers that the structure of the purchase undertaking in the SEC transaction falls somewhere between the two structures previously examined, and as a result investors do run a certain amount of risk on the underlying *Sukuk* Assets.

More specifically, a shortfall in net income resulting in a failure to pay the full amount of any Periodic Distribution Amount or Extra Amount only constitutes an event of default under “Default resulting in non-payment of Periodic Distribution Amount or Extra Amount” if it occurs as a direct result of SEC’s default or negligence in performing its obligations under the transaction documents.

Accordingly, if such shortfalls were attributable, say, purely to the failure by SEC’s customers to pay their bills on a timely basis, then, absent SEC’s default or negligence, *sukuk*-holders would suffer the shortfall without recourse to SEC. (In practice, the risk of this occurring appears to be low based on historic customer delinquency rates and SEC’s ultimate sanction of disconnection, but the risk is far from being completely theoretical.)

This is also consistent with the Fourth Rule in the AAOIFI Statement described above in that it falls within the exception for "negligence or mala fides or non-compliance with stated conditions."[11]

In addition, although the occurrence of an Event of Default entitles investors to have their *sukuk* (and their entitlement to the underlying *Sukuk* Assets) repurchased by SEC, the price at which SEC repurchases them declines over the twenty-year life of the *sukuk*, being set at 100 percent for the first four years and then declining over the life of the issue to just 5 percent in the year before the *sukuk* expire.

The list of events of default is also something of a mixture of bond-like credit events relating to SEC and other events relating more to the *Sukuk* Assets. The Distribution Sector Restructuring Event, in particular, provides for an early termination of the transaction in circumstances where SEC concludes that a government-led restructuring of the electricity sector makes continued servicing of the *Sukuk* Assets impracticable. (This might be the case if, for example, the distribution sector of the industry were restructured so that SEC was no longer generally responsible for billing consumers.) If the *Sukuk* Assets were merely incidental to the structure, then this would be of little importance.

The SEC transaction, while retaining a number of debt-like features, also exhibits a number of more asset-backed elements and the structure of the purchase undertaking reflects this. Investors run credit-risk on SEC's customers and this is accordingly disclosed as a risk factor in the Offering Circular. Conversely, it is not intended that investors should run additional risks arising out of the potential restructuring of the Saudi electricity industry by the Saudi government, and the commercial solution is to enable the investors to exit the transaction if this occurs, potentially receiving a full return of their capital so long as this occurs during the first four years of the transaction.

A further example of risk allocation relating to the *Sukuk* Assets is the "Top-Up of Reserve" provision. This requires SEC to pay additional amounts into the Reserve to cover any shortfalls arising out of either (1) the meter reading tariff and related legislation being amended or revoked or (2) any of the customers whose meters are the subject of the transaction changing their electricity supplier.

The risk of the latter occurring was thought to be relatively low, as residential and commercial electricity consumers in Saudi Arabia do

[11] AAOIFI, *Statement in Relation to Sukuk*, February 2008.

not now generally have a free choice of electricity supplier. Likewise, no change in the tariff structure affecting meter reading was expected at the time of the issue. However, given the final maturity of the *sukuk* (20 years) and the first date at which they could be repurchased (5 years), it is not inconceivable that the electricity sector in Saudi Arabia and the tariff structure could be restructured while the *sukuk* were outstanding. This essentially political risk is hard to quantify, and potential investors might legitimately consider that it was not one that was reasonable for them to bear. Accordingly, the solution here is to allocate these particular risks to SEC, which is in a much stronger position in terms of evaluating these risks and potentially influencing the political outcome.

Again, this illustrates the hybrid nature of the SEC transaction. The transaction is asset-backed, in that investors do run genuine risk on the *Sukuk* Assets, but not all risks relating to the *Sukuk* Assets are borne by investors.

Saudi Basic Industries Corporation ("SABIC")

Saudi Basic Industries Corporation's ("SABIC's") July 2006 SAR3 billion *sukuk* issue was the first such transaction publicly offered in Saudi Arabia under the Capital Market Law. In many ways, it was the precursor of the SEC issue discussed above, and there are many similarities in the overall transaction structure.

SABIC is the Saudi holding company for the SABIC Group, one of the largest petrochemical companies in the world. While SABIC Group's products are produced by various SABIC affiliates and subsidiaries, SABIC itself is primarily responsible for conducting marketing and sales activities for most of its affiliates and subsidiaries incorporated in Saudi Arabia. SABIC receives marketing fees for these activities, which are the subject of various marketing agreements, and the *Sukuk* Assets in the SABIC *sukuk* issue consist of a specified percentage share of SABIC's rights and obligations under these marketing agreements.

SABIC itself issued the *sukuk* directly to investors and transferred the *Sukuk* Assets to a newly incorporated subsidiary to act as custodian for investors. SABIC was then irrevocably engaged by the custodian to act as administrator of the *Sukuk* Assets on behalf of investors.

This appointment is in many ways analogous to the appointment of an originator of receivables as servicer in a receivables securitization. As administrator, SABIC is required to devote the same

degree of skill, care, and diligence as it does in performing its own rights and obligations under the marketing agreements.

The cash flows and financial terms in the SABIC transaction are similar to those in the SEC transaction and we will not set them out in full in this paper. However, the key feature that we will highlight (and which distinguishes these transactions from the *sukuk-al-musharaka* structures discussed above) is that the purchase undertaking is not activated in all circumstances in which investors suffer shortfalls in Periodic Distribution Amounts or return of their capital.

In particular, while non-payment of the full amount of any Periodic Distribution Amount or Extra Amount is potentially an event of default, it will only be an actual event of default entitling investors to have their *sukuk* repurchased by SABIC if the relevant shortfall occurred as a direct result of SABIC's default or negligence in performing its obligations as administrator of the *Sukuk* Assets. Accordingly, investors run both a performance risk on the SABIC Group's continuing to produce products to market under the marketing agreements and a credit risk on group companies in terms of their paying the related marketing fees. This falls some way short of the protection that a typical bond guarantee offers investors and instead provides a degree of recourse similar, in this respect at least, to that in a securitization where the originator defaults in its obligations as servicer.

On the other hand, a full list of corporate bond-style events of default, including cross-default and insolvency-type events, are included in the *sukuk*, all of which trigger an investor right under the purchase undertaking to have their *sukuk* repurchased by SABIC. However, as in the SEC *sukuk* the repurchase price declines over the life of the transaction, falling to 5 percent of the face value of the *sukuk* in the final year before maturity.

This is again illustrative of a hybrid instrument under which investors bear some risk on the *Sukuk* Assets, but not in all circumstances.

APPROACHES OF RATING AGENCIES

Rating agencies generally approach the rating of *sukuk* with purchase undertakings or originator guarantees in a different manner from *sukuk* without such features. We discuss below the published approach of Fitch Ratings ("Fitch") to rating *sukuk*; we understand that broadly

similar considerations are taken into account by the other major rating agencies.

There is no single approach covering all *sukuk*, which is hardly surprising given the range of structures and different credit-enhancement techniques (including purchase undertakings) used.

That said, Fitch categorises *sukuk* issues as being either "originator-backed *sukuk*" or "asset-backed *sukuk* (securitizations)."[12] The first category includes those with purchase undertakings to repurchase the *sukuk* assets at a predetermined price (thereby avoiding valuation risk) and any outstanding periodic distribution amounts.

Fitch comments in relation to these types of transaction:

> [A]lthough *sukuk* are asset-based, the originator's contractual obligations—whether represented by a guarantee or not—clearly determine that the credit risk of the *sukuk* reflects that of the originator rather than the underlying assets. The *sukuk's* Long-Term Rating cannot therefore exceed the Issuer Default Rating (IDR) of the originator, and would ordinarily be in line with the originator's IDR.[13]

Additional risk factors, among other things, may lead Fitch to notch down from the IDR, if appropriate. Notching up would only generally be possible if there were tangible assets that could increase the recovery prospects and where Fitch can be satisfied that the transaction is genuinely secured on such assets.

Local legal factors relating to enforceability of purchase undertakings are relevant, but will often not result in a purchase undertaking supported *sukuk* having a lower rating than the originator's IDR, even where there may be significant potential difficulties in enforcing a purchase undertaking in the originator's jurisdiction. (Although purchase undertakings are frequently governed by English law, there are often uncertainties in GCC jurisdictions regarding both enforceability of English judgments and English law agreements in the local courts.) The reason for this is that similar considerations also apply to conventional bonds issued in the same jurisdiction, and hence these risks will normally already be reflected in the originator's IDR.

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[12] FitchRatings, "Fitch's Approach to Rating *Sukuk*," *Corporate Finance: Criteria Report,* March 5, 2007, pp. 1–4.
[13] Ibid.

Conversely, Fitch would apply more conventional securitization rating methodologies for rating true asset-backed *sukuk*, potentially resulting in a rating higher than the originator's IDR.[14] However, in order for it to do so, the transaction would need to represent a true sale, with investors having first priority over the underlying assets, without any risk of the sale subsequently being overturned by local courts. In many GCC jurisdictions, local legal uncertainties may make it difficult to satisfy these criteria.

CONCLUSIONS

This paper has demonstrated that existing *sukuk* transactions adhere to the Fourth Rule in varying degrees. Asset-based *sukuk* transactions, as exemplified by the JAFZ transaction, do not appear to comply with the Fourth Rule since the obligation for the purchase undertaking is often the same entity as the partner in the *musharaka* and the purchase price for the *Sukuk* Issuer's Units will typically be their original face value. On the other end of the spectrum, asset-backed transactions, as exemplified by the Tamweel transaction, appear to comply with the Fourth Rule, since the purchase undertaking is limited to circumstances that fall within the exception in the Fourth Rule that the *sukuk* manager acts as a guarantor in cases of negligence or mala fides or non-compliance with stated conditions. Transactions that appear to fall in between those ends of the spectrum, as exemplified by the SEC and SABIC transactions, are less clear in their adherence to the Fourth Rule.

It is currently too early for a consensus to have developed as to how best to take into account the AAOIFI Statement in structuring *sukuk* transactions going forward and, in particular, how purchase undertakings may be used. However, while commercial objectives and credit ratings will continue to have a large impact on these transactions, adherence to the Fourth Rule will likely be influential in the structuring of *sukuk* transactions. Nevertheless, given the variety of *sukuk* transactions that have thus far been adopted, particularly those such as the SEC and SABIC transactions that appear to fall in the middle of the spectrum of compliance with the Fourth Rule, transaction parties will continue to have a wide variety of options to structure their transactions and seek to comply with AAOIFI's Statement.

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[14] Ibid.